Quarterly Commentary

September 2021

Entrust

WEALTH MANAGEMENT

Outlook

- **Above Trend but Moderating Growth Expectations**
- **A World in Transition**
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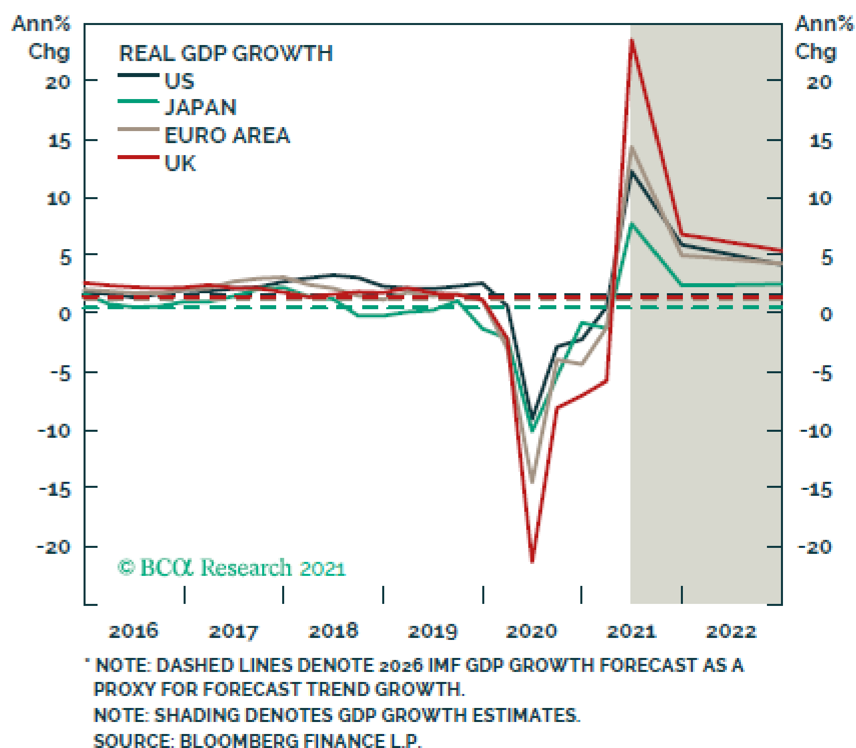
Above Trend But Moderating Growth Expectations

Slowing rates of growth and less supportive monetary policy is common in the second year of a bull market and this cycle appears no different.

However, whilst economic growth expectations are moderating we expect growth will continue at an above trend rate over the near term, driven largely by the reopening of economies. We also expect monetary conditions to remain supportive of growth although acknowledge central banks are moving to a less accommodative stance.



Such an environment can often be one of lower returns with higher volatility but with a recession unlikely in the near-term, risk assets such as equites and property are expected to continue to outperform cash and government bonds.

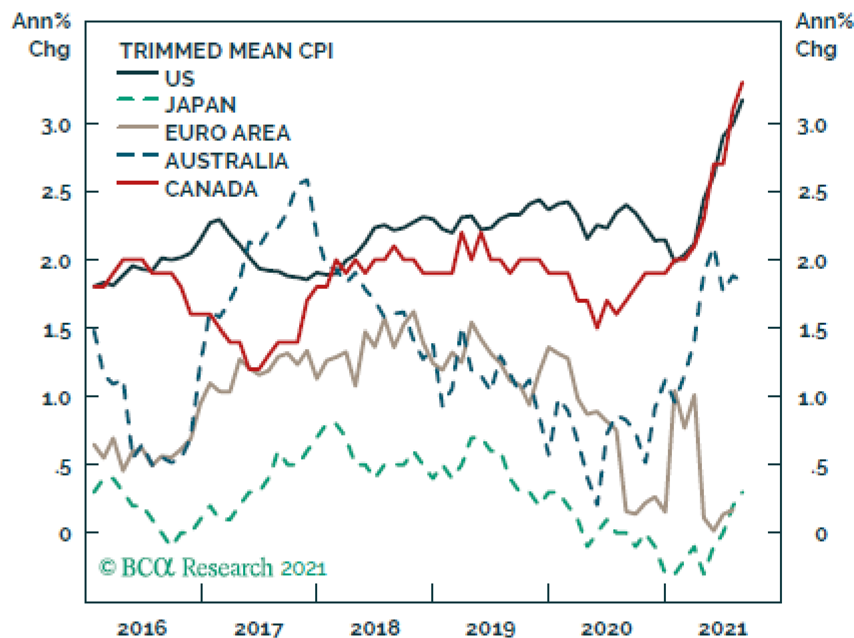
A World In Transition

There are a number of impactful transitions under way that present both opportunities and risks for investors. In the discussion below, we highlight some of the key ones dominating our thinking.

Central Bank policies

As mentioned above, an increasing number of central banks are shifting their outlook towards a less accommodative stance with an evolving inflation outlook a key reason why.

Driven by pandemic-related price increases from a small basket of items, until now, most viewed the recent rise in inflation as transitory. However, as can be seen in the chart below, measures of underlying inflation, which remove some of the pandemic outliers, are rising. This suggests the inflationary pulse is becoming more broad based.



Another important indicator monitored by central banks when considering monetary policy is wages growth. At the headline level, this remains within historical norms albeit with upward momentum. Within that though, some sectors affected by boarder closures are showing above trend growth.

In response, central banks have begun removing stimulus via reduced asset purchases. Investment markets have reacted by bringing forward their expectations of when cash rates might rise. As an example, our asset allocation consultant, BCA Research, currently expects a late 2022 lift-off for US cash rates, which compares to the original expectations of the US Federal Reserve of not until at least 2024.

While there are reasons to believe longer-term bond yields may be capped somewhat, the transition away from the ultra-supportive monetary environment we have experienced since 2020 may cause some not so insignificant market gyrations along the way.

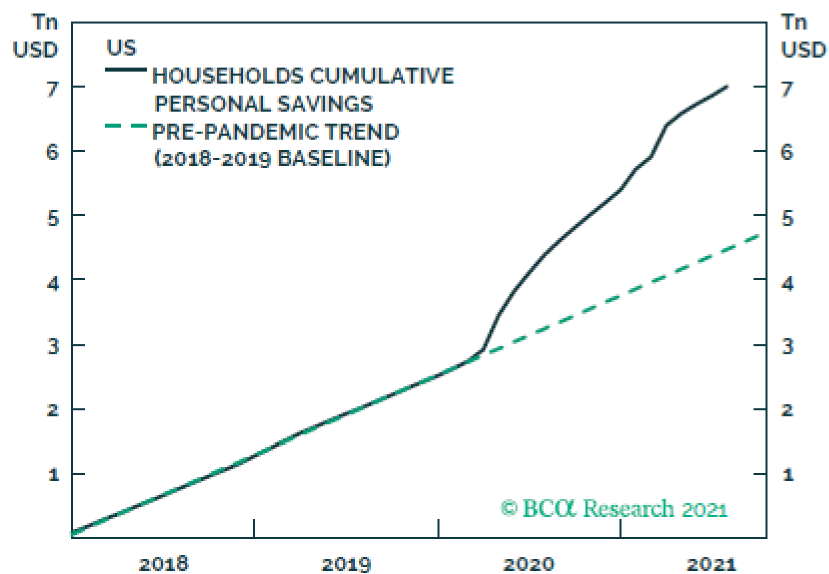
A recent example of this was seen in the Australian bond market following the RBA's decision to remove themselves as a buyer of April 2024 bonds to maintain the yield at 0.10% as part of its yield curve control (YCC) program. Bond markets reacted by selling off sharply, driving the yield on this bond to around 0.60% while the 10-year bond spiked to 2.10%.

Such moves can have flow on effects in equity markets with the ASX 200 falling 1.5% on the same day. Given equity market valuations have been a beneficiary of the low interest rate environment it is reasonable to assume that as rates transition higher we will get further bouts of equity market volatility.

Removal of emergency fiscal support

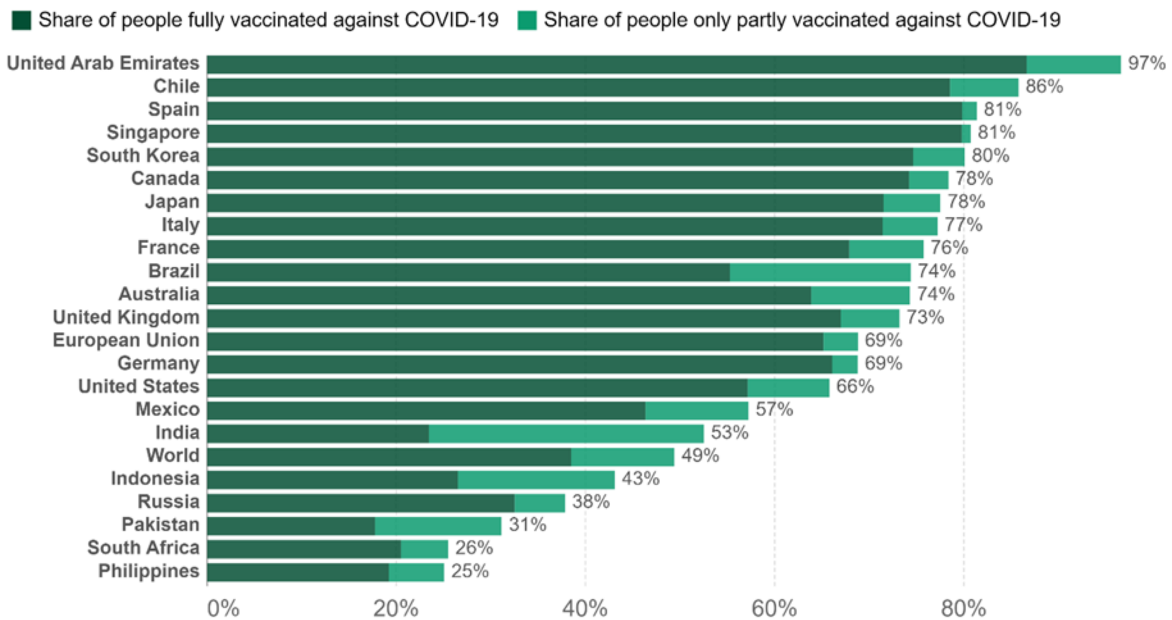
Thanks to generous government support programs, household savings are currently at very high levels. As an example, excess savings accumulated by US households over the past 18 months is estimated to be USD$2.5 trillion (approximately 10% of GDP).

This should provide a supportive backdrop for consumer spending and consumption. However, these enhanced unemployment benefits have come to an end with many recipients now needing to transition back into the workforce. Any delays in this or concerns around the prospect of further lockdowns may see consumers maintain a higher savings buffer than normal leading to lower consumption than consensus expectations. With consumption around two thirds of many developed markets GDP this could be an important swing factor for growth assumptions.



Living with Covid-19

As the world increases its vaccination levels, discussions have moved from virus eradication to virus management.



The main fear around COVID-19 was always the potential for healthcare systems to be overwhelmed by critical cases resulting in unacceptable death rates. If we accept that COVID-19 is here to stay in one form or another and economies cannot remain shut forever, management via vaccinations would seem a logical way forward.

The benefits of this should be a continuation of global economic growth and the removal of a number of economic frictions, such as supply chain blockages and the cross-border movement of workers.

However, the transition back to a more normal state of affairs poses a number of challenges. Firstly, how long vaccinations provides effective protection is an evolving story with booster shots already widely recommended after 6 months. Secondly, any new strains of the virus that current vaccinations may not adequately protect against pose a risk to a smooth reopening process.

As confident as some governments are about their ability to live with COVID-19 the truth is it will take time to fully appreciate whether or not this is a reality. Any hiccups along the way would obviously be detrimental to economic growth and may test the ability of governments to provide adequate support.

On a positive front, research into medical solutions for COVID-19 continues at pace with Pfizer recently announcing some encouraging trial results from an antiviral pill for COVID-19.

China and common prosperity

In August 2021, Chinese President Xi Jinping announced a new 'common prosperity' plan for China that will underpin their future national policy. His aim appears to be to restructure the economy via a redistribution of wealth to grow the middle class, increase taxes and raise regulations on old growth sectors, such as property and low-value manufacturing, in favour of new growth sectors like technology and high-value manufacturing.

One of the reasons why is thought to be Xi's push to secure a third term as leader at the 20th Party Congress in 2022. Another theory is that the government has been unsuccessful in transitioning the engine of economic growth to domestic consumption as it nears the end of the export and investment led growth cycle it has benefited from for decades.

Common prosperity is not a new theme for China, its origins stretch back to Mao Zedong in the 1950's. In the 1970's Deng Xiaoping kicked off China's export driven era stating 'Let some people get rich first' while also setting an expectation that those that were allowed to prosper would 'lead other regions and people to gradually achieve common prosperity.' It would seem that Xi views that 'later' is now.

From an investment perspective, China offers significant potential but it is clear the political risk factor has risen. After allowing some to amass wealth the Party clearly wants to reign in the power that comes with that. This adds complexity and uncertainty to the investment thesis for China.

Also, the attempt by the Party to shift the economy away from excessive property speculation at a time when its competitive advantage in manufacturing is diminishing adds downside risk to China's growth outlook. This has been a key factor in the fall in the price of iron ore from above $200 to below $100.

All of this considered, it is hard to ignore the fact that an ability for corporations to align themselves with a rapidly growing middle class in one of the world's largest economies is a compelling investment theme that will provide opportunities.

Energy transition

Another key transition underway is the move towards a lower carbon future via an increasing focus on renewable energy. For the global community this is an important shift towards a more sustainable future. From an investment perspective there are some interesting implications that will flow from this.

With an increasing focus on environmental, social and governance (ESG) factors, investors are demanding investment capital be directed away from traditional carbon emitting energy sources. In many countries, government policies and regulations are also being put in place designed to accelerate this transition. This has resulted in underinvestment in new sources of fossil fuels at a time when demand for energy is increasing. This has caused a rally in the oil price, a positive for producers that are able to deliver into that price strength, but also adds to inflationary pressures.

Very recently we have also witnessed an energy crisis in China due to depleted coal inventories and low hydroelectric generation. Similarly, low output from renewable

sources in Europe and the UK saw a rush to natural gas and coal to meet their energy needs, causing a sharp rise in the price of both. It is also interesting to note that the most recent European summer was characterised by some of the lightest winds in decades, UK-based power company SSE stated that its renewable assets produced 32% less power than expected.

This highlights that as desirable as the end result of a sustainable energy future is, the transition will need to be carefully managed. Failure to do so could undermine longer term goals in favour of short-term needs. Traditional energy sources will be required in this transition phase and within that lie investment opportunities.

The renewable energy push itself also presents opportunities as a wall of capital will be pushed in that direction over coming decades so positioning to benefit from that money flow makes sense. As part of that, the build out of the required grids and infrastructure as well as the ramp up in electric vehicles and batteries will require significant volumes of base metals. This thematic we believe will help to offset some of the downside risk for commodity companies from slowing Chinese growth.

Implications For Portfolios

- With above trend economic growth driven by the reopening of economies together with supportive monetary and fiscal policies, we maintain a moderately pro-risk stance towards equities and credit instruments.
- As we move through the various transitions underway we expect to see some sharp adjustments in markets at times. This is likely to lead to periods of heightened capital volatility.
- A lift in earnings expectations has improved equity market valuations but in general they remain above long-term averages. Rising bond yields and a moderating growth outlook provide potential headwinds for valuations so this is something we are being mindful of in our stock selection and position sizing.
- Given the two points above we expect equity markets may continue to be in a consolidation phase for the near future with dividend yields an important contributor to total return.
- Despite near term risks around China’s growth we remain comfortable with the longer-term outlook for commodities and in particular those that will be beneficiaries of the energy transition cycle including copper, nickel and lithium.
- With the broadening of the inflation impulse we have increased our exposure to gold for its potential risk management benefits in the current environment. In simple terms, the key downside risk for portfolios, in our view, is a higher than expected lift in bond yields caused by increasing inflation expectations. In that scenario there is a risk equities and bonds move in the same direction reducing the normal diversification benefits of holding both. Gold on the other hand should be a beneficiary and become a valuable source of diversification.
- On the expectation of higher bond yields we remain underweight interest rate risk with a preference for floating rate or shorter dated credit and hybrid instruments.
- We are comfortable holding higher levels of cash if necessary to both reduce overall portfolio volatility and provide the ability to participate in new opportunities as they arise.

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